Balfour Beatty

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KPMG REVIEW, VALUATION OF INVESTMENTS PORTFOLIO & TRADING UPDATE

Balfour Beatty, the international infrastructure group, today announces the summary findings from the review of the UK construction business by KPMG, an updated valuation of the Investments Portfolio and a trading update in advance of the Group's full year results in March.

SUMMARY

- As a result of the KPMG review and recommendations the Board expects to reduce 2014 UK construction profits by a further £70 million, comprising:
  - £20 million relating to the difference between the reported contract positions, as at August 2014, and KPMG's assessment as at the same date; and
  - £50 million relating to an assessment of contract forecasts and subsequent deterioration in project performance up to the end of December 2014
  - In addition, as recommended, the Board will assess the overall level of contract risk provisions in the UK construction business in light of the operational issues identified and will announce the outcome at the full year results in March
- Issues principally restricted to previously highlighted delivery units: Engineering Services, and London (including major projects buildings) and the South West regions of the Regional business
- Directors' Valuation of the existing Investments Portfolio increased to £1,300 million
- Investments business forms an integral part of the Group's business model
- Outside of UK Construction, no net material change in underlying trading since the Q3 trading update
- In order to maintain a strong balance sheet, the proposed share buyback of up to £200 million has been cancelled; dividend policy to be reviewed in March at time of full year results

Leo Quinn, Group Chief Executive commented: "The summary report on UK Construction is an important step in drawing a line under a period of uncertainty for our customers, and enabling us to focus fully on delivering value.

"I was never in doubt that there was a great deal of work to be done to restore the Group to strength. Balfour Beatty is a large organisation which had become too complex and too devolved for adequate line of sight and financial control. The key is that these issues can be put right and we now have clear action plans in hand. Significant opportunity exists across the Group to drive reduced costs, improved profits and strong cash generation to the full benefit of our shareholders.

"The updated valuation of the Investments Portfolio, together with its income stream, clearly demonstrates its ongoing ability to deliver significant value. Within Balfour Beatty's business model, it also provides a strategic anchor both with key customers and to the Group's growth prospects, earnings and balance sheet.

"Working changes into the culture of the Group will take time and discipline, but everything I have seen so far reinforces my first impressions about the depth of engineering capability in Balfour Beatty, and the expertise, commitment and passion of our people. Our goal now is to ensure that the value delivered to our customers by what is an exceptional workforce, translates into best-in-class performance and returns."

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PART I: SUMMARY FINDINGS FROM THE KPMG REVIEW

Balfour Beatty announced on 29 September 2014 that KPMG would undertake an independent review of the contract portfolio within Construction Services UK (CSUK), given the continued inconsistent operational delivery across some parts of that business.

The summary findings were presented to, and considered by, the Board last night. The key findings and recommendations have been presented below.

Scope of the Review

As announced in September, the review focused on bidding and tendering disciplines, commercial controls, 'cost to complete', contract value forecasting, reporting at project level, and project reporting and reviewing.

KPMG reviewed a sample of 127 projects across CSUK as at August 2014. The selection criteria were:

- A sample consisting of the majority of the projects that comprised the profit shortfalls announced in September and July 2014; and
- A risk based sample of other projects from across CSUK which did not form part of the profit shortfalls.

The sample, measured by August 2014 year to date revenue, covered approximately 74% of Engineering Services and 58% of Major Projects. Across the four Regional business units it covered 33% of August 2014 year to date revenue in London and the South East, 19% of the South West, 12% of the North and Midlands and 14% of Scotland. Overall the sample comprised 36% of CSUK's August 2014 year to date revenue.

Key findings

The majority of the issues highlighted are contained within delivery units previously identified as having issues: Engineering Services, and the London (including major projects buildings) and South West regions of the Regional business. These contracts account for less than 10% of CSUK's August 2014 year to date revenue.

KPMG has identified the following root causes of poor operational performance:

1. **Bidding** – Tendering at very low margins with optimistic assumptions around cost, programme and procurement savings, and inadequate provisions for risk.
2. **Commercial and contract management** – Insufficient local management challenge and review of contract performance, failure to recover genuine contract entitlement due to poor contract administration and optimistic assumptions on contract penalties.

3. **Accuracy of cost and programme forecasting** – Insufficient visibility, control and understanding on actual versus reported contract performance.

The Group considers insufficient visibility on project deterioration was compounded by an overly complex reorganisation programme that led to high levels of employee turnover at a time of extremely challenging market conditions.

Recommendations

The Board is acting on the recommendations of the KPMG review to strengthen performance over the project lifecycle through:

1. **More rigour in tender assessments –** Improve tender review processes through improved guidance, improved operational inputs, earlier and ongoing risk management assessment, additional independent oversight and appropriate allocation of resource. A review of a sample of recently bid contracts shows a tightening up of tender processes but also demonstrates that further standardisation of the bidding process is required.
2. **Improve accountability for project performance** - Ensure project managers have greater financial and commercial accountability for project performance with an appropriate set of project performance KPIs. More robust challenge and review of contract performance by local management.
3. **Accuracy and timeliness of forecasting** – Increased focus on identifying, understanding and reporting risks inherent in projects and the implications on financial performance on a timely basis, and enhanced project reporting supported by consistent application of strong commercial management and contract administration processes.
4. **Group policies –** Improve and reinforce Group policies to commercial and local financial management ensuring rigorous application across all projects.

2014 financial impact

Having received and considered KPMG's summary findings and recommendations last night, the Board expects to reduce 2014 UK construction profits by a further £70 million, comprising:

- £20 million relating to the difference between the reported contract positions, as at August 2014, and KPMG's assessment as at the same date; and
- £50 million relating to an assessment of contract forecasts and subsequent deterioration in project performance up to the end of December 2014.
- In addition, as recommended, the Board will assess the overall level of contract risk provisions in the UK construction business in light of the operational issues identified and will announce the outcome at the full year results in March.

Actions underway

Since Leo Quinn became Group Chief Executive on 1 January he has actively engaged with UK and US site teams and has worked with operational leadership.

The recommendations on the UK Construction business will be implemented within the delivery units with immediate priority. Importantly the Review has helped distinguish those units requiring strong corrective action from the remainder which are performing more effectively. This in turn highlights the need to drive greater transparency and accountability. As a first step in addressing this, the UK structure will be simplified and de-layered with the Major Projects construction business reporting to the Group Chief Executive with immediate effect. Similar rigour will be applied in assessing the Group's processes and project performance across all of its major markets.

In addition, Leo Quinn is launching a group wide programme for transformation, with an initial phase to drive significant reduction in overhead costs and substantially improved cash flow generation. In this process, engineering, project management and customer-facing resource will be actively preserved and strengthened. The first phase will also address, among others, the following critical areas:-

- Strengthen the Group's bid approval and project delivery review processes
- Drive a culture of productivity and cash generation through systematic project-level training
- Upgrade leadership and align all incentive grades with programme targets
- Establish standard reporting to increase transparency

Against the backdrop of current earnings and in order to maintain balance sheet strength during the Group's transformation, the proposed share buyback of up to £200 million is being cancelled, and the dividend policy will be reviewed at the time of the full year results in March. At the same time the Group will re-engage with the Pension Trustees on the pending pension deficit payment.

This programme will be underpinned by a clear commitment to improve direct communication and accountability throughout the Group. We will keep our employees and the market updated with our progress.

PART II: UPDATED VALUATION OF INVESTMENTS PORTFOLIO

Highlights

- Directors' Valuation (DV) of the Investments Portfolio increased to £1,300 million. This is consistent with an independent valuation of the Investments Portfolio
- Significant pipeline of future investment opportunities, to drive future value for the portfolio
- Directors estimate the value of the future pipeline at an additional 10% - 15% of the DV of the Investments Portfolio
- Strategic importance of a strong and growing investment portfolio working in partnership with a well managed construction business
- Investments division generates value for other parts of the Group and provides an important presence as an owner and operator in the infrastructure market
- The strategy of actively managing the Investments Portfolio to crystallise value at the optimal point maximises returns for the Group while providing underlying strength to the balance sheet.

Overview

Balfour Beatty has historically updated the DV of the Investments Portfolio every 6 months, using a constant set of valuation assumptions. In 2014, following a series of disposals in excess of the DV it became clear that the existing methodology no longer provided a good indicator of value. As a result, a revised valuation methodology was published which moved the DV closer to a market valuation, but retained a number of conservative assumptions.

The conservative nature of the assumptions was clearly illustrated by the 28% premium to the DV realised by the disposal of the Pinderfields and Pontefract hospitals in October 2014. This has led to a further detailed reassessment of market trends and valuation assumptions to move closer to a market value.

The Investments business is strategically important to the Group as a whole, and also offers two additional sources of value for shareholders. Firstly, the pipeline of future bidding opportunities has value in itself. Secondly, new investment opportunities bring wider benefits in terms of value and experience for other Group businesses.

The Board recognises the strategic imperative of maintaining an appropriately sized Investments Portfolio, which spans across the Group's strategic markets and across the asset lifecycle. This maintains credibility in bidding for new work, and enables Balfour Beatty to partner more closely with its clients.

A key component of the Investments strategy is the active management of its assets to maximise returns by crystallising value at the optimal point in their lifecycle. This point is typically once the physical asset has been built and has operated successfully for a period of time. Holding the assets over time not only provides capital growth in the underlying assets, as the risks and the discount rates on which they are valued reduce, but also provides a strong foundation of high quality cash earnings to the Group. In this way the Investments Portfolio offers the most attractive return of any asset class available to the Group.

Directors' Valuation of the Investments Portfolio

The DV of the Investments Portfolio has increased to £1,300 million as at 31 December 2014. KPMG has undertaken an independent valuation in aggregate of the Investments Portfolio and the DV is consistent with KPMG's conclusion. This compares with the previous DV of the portfolio of £1,051 million as at June 2014. The UK portfolio valuation increased to £963 million, from £801 million as at June 2014. The North America portfolio valuation increased to £337 million from £250 million as at June 2014.

The principal drivers of the increase in valuation are lower discount rates and revised cash flow assumptions on the UK portfolio and improved cash flow assumptions on the North American portfolio.

The DV is now closer to current market values, albeit values, particularly in the UK, may continue to move up in the future given the ongoing imbalance between the supply and demand of high quality investments in the secondary market. The valuation methodology in the UK remains unchanged, but the assumptions have been updated to reflect current market conditions. For the North American portfolio concession management costs were revised to reflect lower overhead costs, bringing it in line with the treatment in the UK portfolio.

The conservative assumptions used historically resulted in smooth and predictable changes in the portfolio value over time. Moving closer to a market value increases the DV, however future market changes could increase or decrease this value.

Changes to the valuation assumptions are detailed in Appendix 1.

Pipeline of future business

The Directors have assessed the value that the investments business expects to organically generate from the pipeline of future business opportunities. The Directors estimate the value of the future pipeline at an additional 10% - 15% of the DV of the Investments Portfolio.

The range and scale of the Investments Portfolio provides insight into the longer term potential of the Investments business, as it evolves to access new market opportunities. The business has established an outstanding reputation in the market which, when coupled with the experience and extensive relationships built over the last 17 years, provides an effective and competitive platform from which to source new opportunities. This also offers the opportunity for future downstream work on existing projects. The depth of expertise allows the business to assess and manage risk, through the asset lifecycle, and ultimately deliver significant profits and cash for the Group.

This has been demonstrated in Balfour Beatty's recent appointment as Preferred Bidder for a £260 million justice complex project for the City of Indianapolis/Marion County in Indiana, United States. Whilst this represents Balfour Beatty's first project in the justice sector, the business brings a vertically integrated platform of investment and construction to the project, bolstered by a proven track record.

Synergies from the Investments business being an integral part of the Group

The current pipeline of future business for the Investments business is expected to generate £2 billion of new work for other Group companies over the next five years. Historically, where the Group has been able to deploy its investments, construction services and support services businesses together, it has generated higher margins.

The expertise, experience and relationships of the Group's construction activities are important to the Investments business's ability to successfully source opportunities and manage project development risk, which is fundamental to the delivery of attractive returns in the future. In return, the insights gained by the Investments business from operational information is transferrable to other parts of the Group in conventional bidding processes.

PART III: TRADING UPDATE

Excluding the impact of the KPMG findings in Construction Services UK, there has been no net material change in underlying trading across the Group as a whole, since the last trading update on 18 November 2014.

However, within this, the mechanical and engineering joint venture in the Middle East continues to operate in challenging markets, whilst the highways maintenance business in Support Services has

performed strongly.

It is expected that the year-end order book will be slightly lower than the third quarter which stood at £11.7 billion. The Group ended 2014 with a net cash balance of approximately £180m.

ENDS

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Additional information

A presentation to analysts and investors will be made today at 08.30 (UK time) via webcast.

Please register by visiting http://gaia.world-television.com/BalfourBeatty/webcast/index.html

Alternatively you can dial in using the numbers and password below:

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APPENDIX I - DIRECTORS' VALUATION OF THE INVESTMENTS PORTFOLIO

	FY2014		
Summary valuation movements (£m)	**UK**	**US**	**Total**
Opening valuation	**801**	**250**	**1051**
Cash invested	47	-	47
Cash received - distributions	(34)	(21)	(55)
Cash received - disposals	(62)	-	(62)
Net cash received	(49)	(21)	(70)
Unwind of discount on NPV	30	12	42
New project wins	15	3	18
Disposal gains	14	-	14
Inflation, FX & operational gains / losses	11	24	35
BBIP	9	-	9
Closing valuation using previous assumptions	**831**	**268**	**1,099**
Change in discount rates	14	(16)	(2)
Projected performance improvements	112	85	197
Change in macroeconomic assumptions	6	-	6
Closing valuation using revised assumptions	**963**	**337**	**1,300**

PPP portfolio valuation by sector (£m) (2014 number in brackets)	**FY 2014**	**HY 2014**
Roads - 13 projects (13)	467	387
Hospitals - 4 projects (5)	225	216
Schools - 8 projects (8)	102	60
Other - 13 projects (11)	149	128
UK total - 38 projects (37)	943	791
US military housing - 21 projects (21)	322	240
Hospitals - 2 projects (2)	4	6
Other - 5 projects (3)	11	4
North America total - 28 projects (26)	337	250
BBIP	20	10
Total - 66 projects (63)	**1,300**	**1,051**

[1] Number in parentheses represents number of projects as at HY 2014

PPP portfolio valuation by phase (£m)	**FY 2014**	**HY 2014**
3+ years post construction - 10 projects (8)	254	109
0-3 years post construction - 18 projects (18)	634	588
Construction - 14 projects (13)	55	60
Preferred bidder – 3[1] projects (3)	15	44
US military housing 21 - projects (21)	322	240
BBIP	20	10
Total - 66 projects (63)	**1,300**	**1,051**

[1] This excludes 2 projects at preferred bidder stage in the US, due to nature of procurement process

Directors' Valuation – Changes to valuation assumptions

UK PPP portfolio

All UK projects have been individually assessed to update assumptions, where appropriate, to reflect recent secondary market transactions, as seen on the sale of the Pinderfields and Pontefract hospitals in October 2014. The valuation is for the portfolio as a whole, rather than assuming the assets are sold individually. The key changes from the assumptions made as at June 2014 are:

UK Discount rates

A range of discount rates have been applied across the portfolio, between 7.0% and 15.0%, depending on the risk profile of each investment. Discount rates on operational, availability based projects or projects with proven demand have discount rates towards the bottom end of the range. Projects with unproven demand, project specific risks and projects in construction have higher discount rates. Projects which exhibit a combination of these risks have discount rates towards the top end of the range. In overall terms, the weighted average discount rate applied to the UK portfolio is 7.8% (from 8.1% at HY 2014).

A 1% change in the discount rate would change the value of the UK portfolio by approximately £107 million.

UK Macroeconomic assumptions

These are unchanged, with the exception of long term deposit interest rates which have been increased from 3% to 3.5%.

UK Cash flow assumptions

Further cost savings in line with those currently being assumed in the secondary market have been forecast on a project by project basis for operational projects. This has reduced cost assumptions, particularly in lifecycle and SPV costs, beyond the levels assumed as at June 2014.

UK Capital structuring

The capital and legal structure of some buyers may result in a lower tax burden under their ownership. This may result in higher valuations being ascribed to the assets in competitive bid situations. A larger proportion of this valuation upside is now reflected in the DV.

North America PPP portfolio

The North American portfolio is composed predominantly of the military housing business, and accounts for 96% of the value of North American assets. The valuation assumptions for the military housing business have been revised in light of increasing project maturity and through comparison with similar projects in the UK portfolio, in the absence of sufficient comparable transactions in North America. Where previously a change in discount rate has been used to proxy overall value increases, this has now been revised to assess both underlying cash flow forecasts and discount rates.

The key changes to the military housing valuation assumptions are noted below:

North America Cash flow assumptions

The revised forecast cash flows reflect lower overhead costs, specifically lower allocations of central corporate overhead, bringing it in line with the treatment in the UK portfolio. This assumes that current market participants would incur minimal incremental cost on buying the assets, and therefore is reflected in the valuation.

North America Inflation

Income inflation assumptions have been reassessed in light of experience over a sustained period of time. This relates to inflation on housing allowances on a small number of projects. Construction costs (which form the basis on which certain fees are earned) have also been increased in line with historical inflation trends and to reflect the drive for more energy efficient buildings.

North America Discount rates

Discount rates on military housing projects have been increased slightly in conjunction with the reduction in overhead costs noted above. Given that a large number of investors in the US pay tax, the methodology has been reverted to discounting post tax cash flows rather than pre-tax cash flows. This makes discount rates on military housing projects in the US more directly comparable with those on PPP projects in the UK.

The other investments in the North America portfolio are more directly comparable to PPP and student accommodation projects in the UK and have been valued on similar bases, taking into account the risk profiles and also the maturity of the domestic secondary markets.

Overall discounts rates between 7.5% and 11% on post-tax cash flows have been applied to projects in the North America portfolio. The weighted average discount rate on this portfolio is 8.1% on post-tax cash flows (or 12.2% using the pre-tax cash flow basis previously (from 11.2% at HY 2014)).

A 1% change in the discount rate would change the value of the North America portfolio by approximately £48 million.

Ends